

## SEC Examinations Division Focuses on Principal Transactions and Cross Trades in Fixed Income Markets

AUGUST 2, 2021

The Securities and Exchange Commission's ("SEC") Division of Examinations published a Risk Alert on July 21, 2021 (the "Risk Alert") detailing certain observations made during the course of an "examination initiative," or sweep, of registered investment advisers that engaged in cross trades, principal transactions (or both) involving fixed income securities. The Risk Alert follows and expands upon a 2019 risk alert that highlighted the most common compliance issues observed by the staff related to principal and agency cross trades under the Investment Advisers Act of 1940.

According to the Risk Alert, nearly two-thirds of the examined advisers received deficiency letters, and the vast majority of the deficiencies identified were related to: (1) compliance programs (e.g., policies and procedures adopted pursuant to the "Compliance Rule"), (2) conflicts of interest, and (3) written disclosures, in each case as they relate to principal transactions and cross trades. The Risk Alert describes the common deficiencies identified and recommends certain best practices related to these topics.

Regarding compliance policies and procedures, the Risk Alert explains that many advisers had policies and procedures that:

- Were inconsistent with the advisers' practices,
- Lacked certain considerations or guidance necessary for adviser staff to properly implement them, and/or
- Were not effectively tested.

Regarding conflicts of interest, the Risk Alert explained that advisers often had conflicts of interest associated with cross trades that were not identified by the advisers, and/or that were not mitigated, disclosed, or otherwise addressed by the advisers' compliance programs.

Regarding written disclosures, the Risk Alert explained that advisers often:

- Omitted certain relevant information concerning cross trading activities in their Form ADVs,
- Had no disclosures regarding the conflicts of interest associated with executing such trades in their Form ADV Part 2As, and/or

- Did not include disclosures in their Form ADV Part 2As, advisory agreements, and separate written communications to clients.

Staff then provided recommendations for advisers related to their compliance programs, such as setting clear standards, conducting testing of policies and procedures, providing detailed and comprehensive disclosures, and including disclosures in multiple documents.

The Risk Alert highlights examination staff’s focus on principal transactions and cross trades. Registered investment advisers should expect staff to request information regarding these issues in examinations, and we therefore recommend taking a proactive approach by building compliance programs that comprehensively address principal transactions and cross trades. In this regard, investment advisers should also periodically determine whether they have engaged in principal transactions and/or cross trades, examine whether such transactions were consistent with their policies and procedures, and remediate and mitigate any related issues as necessary.

For further information, please contact the authors or your Winston relationship attorney.

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